

FUTURE ISSUES FACING BOSTON:
FINANCING OF THE CITY'S OPERATING AND
CAPITAL CONSTRUCTION PROGRAM

by

J. Chester Johnson

Prepared for the John W. McCormack
Institute of Public Affairs

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This paper reviews the important factors affecting the current status of debt finance and debt management by the City of Boston, including the City's significant credit problems and the financing implications. While significant challenges to Boston's finance and debt management have recently been met in part through a combination of fiscal austerity measures and altered operating and financing approaches, there are important new debt financing challenges facing Boston in 1984 and beyond.

Among the more important financing and debt management issues facing the City include the City's need to finance cash flow shortfalls, the City's restricted access to capital sources, the perceptions of the credit rating agencies and other major financial institutions toward Boston's securities, and the appropriate allocation of discretionary funds for capital construction projects in the City.

The debt finance and debt management issues facing Boston in 1984 are substantial. Taken in context, however, they suggest that the City's 1984 debt and credit policies should be directed toward meeting the immediate financial needs while at least protecting, if not enhancing, the City's current credit position. The City faces a thin cash flow early in 1984 and has to retire \$25 million of bond anticipation notes on June 29, 1984. As a result, the City faces an immediate need to issue long-term, limited tax bonds in Spring 1984 in order to avoid a potential serious cash flow shortfall.

The City also has an ongoing need to access the short-term market to keep itself solvent. First, the City routinely experiences a thin cash flow balance at various points during its fiscal year. Second, the majority of property taxes, which represent the principal source of revenues, is received in November and May of each year. Hence, the City will have to issue short-term debt annually in an

amount of approximately \$65 million in most years. Thus, the City's ability to convince investors to purchase short-term debt to finance these shortfalls will depend on the maintenance and enhancement of the City's basic credit worthiness.

As history demonstrates, cash flow shortfalls result in political and financial crises with effects that linger well beyond the year of the shortfall. In issuing long-term debt late in fiscal 1984, the City could sell as much as \$45-50 million in long-term, general obligation bonds. If the City sold securities in this amount, approximately half of the bond proceeds could be applied to the payment of the bond anticipation notes, with the other half of "new" funds being available to fund capital projects in fiscal 1985. There are numerous capital and rehabilitation purposes that could be financed by these "new" monies, though some of which may be restricted by court-mandated expenditures.

While the \$45-50 million debt issue would meet the immediate financial needs, special emphasis must be given to enhancing Boston's credit position in 1984 and beyond. There are four major factors that have been identified by credit analysts in the financial community as negatively impacting the City's credit position. The first is the large degree of fixed costs: the City's expenses for education, health and hospitals, debt service, mass transit and pension are financed directly from the City's operating budget. These expenses put substantial pressure on Boston's limited revenue sources and as a result, cause concerns about Boston's ability to access sufficient revenues to pay all of its obligations.

The second factor that negatively impacts Boston's credit standing is the inability of the City to translate its economic resources into a revenue source. The City's ineffectiveness is largely due to the restrictions imposed on its ability to impose and raise taxes. As a result, the City's revenue sources are largely unresponsive to any economic upsurge occurring in Boston. One strategy to turn some of the economic activity into revenues for the City may be to continue to

access state aid which is made available through annual appropriations by the Commonwealth, since state revenues are more sensitive to economic activity. However, this source is indirect and is subject to annual appropriation; expansion of revenues that are more under the control of the City itself would be met more favorably by the credit markets.

The third factor limiting Boston's credit position is the City's inflexible revenue sources, especially its dependency on property taxes, which are now subject to special budgetary limitation. Boston's tax structure is highly restricted and, as a result, will continue to hinder the City's credit worthiness.

The fourth negative factor is the disproportionate assessment refunds that have been and will continue to be paid by the City. The financial strain imposed by these claims served to further weaken Boston's financial situation. Monies the City committed to pay these refunds were not available for other potential City uses. However, it appears that the payment for the majority of these liabilities has been established, and the credit problem imposed by these liabilities has been lessened in fiscal 1984. Until all of the Tregor and related obligations have been retired, the specter of the remaining payments for these liabilities will remain a credit concern to the investment community.

Other factors, including among others, the outcome of the City's labor negotiations, the need to alter the City's debt repayment schedule, etc., will also impact the perception of Boston's securities and its ability to attract the necessary investors for the City's bond and note financings. The City will have to actively pursue those policies and procedures that will strengthen the City's credit in the eyes of credit analysts and potential investors in order to ensure that the City maintains the sound debt finance and debt management necessary to keep the City financially and politically viable.

Statement of Issue

This paper reviews the important factors affecting the current status of debt finance and debt management by the City of Boston, including the City's significant credit problems and the financing implications. While significant challenges to Boston's finance and debt management have recently been met in part through a combination of fiscal austerity measures and altered operating and financing approaches, there are important new debt financing challenges facing Boston in 1984 and beyond.

Among the more important financing and debt management issues facing the City include the City's need to finance cash flow shortfalls, the City's restricted access to capital sources, the perceptions of the credit rating agencies and other major financial institutions toward Boston's securities, and the appropriate allocation of discretionary funds for capital construction projects in the City.

II. Key "Problem" Areas

Several of the major debt finance and debt management problems facing the City are discussed below:

A. Cash Flow Requirements

Absence of cash for a government leads to institutional, financial and political impotence. For Boston, the major City revenues (e.g., property taxes) are due in November and May of each year, while monthly expenditures tend to remain fairly constant throughout the year (although there are certain exceptions). As a result, the City typically needs to issue tax anticipation notes annually in the amount of approximately \$65 million in anticipation of receipt of property taxes. In this respect, the City's financial lifeline remains its ability to sell short-term debt to cover the inevitable shortfalls before property taxes are received. In general, the City should sell sufficient short-term debt at the beginning of the fiscal year, i.e., August-September, in an amount that will provide a cushion large enough to cover potential shortfalls during the entire year.

However, the reason that only \$25 million in tax anticipation notes has been sold thus far by the City for fiscal 1984 was a result of the fact that tax bills were expected to be sent in October, 1984 so that sufficient monies would be

received by the City from the collection of property taxes in November. Because of the large cash influx in early fiscal 1984 from the delay of collections in fiscal 1983, the City found it difficult to justify even a modest \$25 million borrowing, because of the sizeable amount of cash from property tax receipts on hand in early 1984, and to comply with regulations of the Internal Revenue Service regarding the amount of tax-exempt debt that can be issued by a governmental entity in anticipation of taxes.

It should be noted that the City at present has approximately \$40 million of additional tax anticipation notes that can be sold with the same security provisions as the outstanding \$25 million during fiscal 1984. Access to borrowed funds to meet the cash shortfalls will be necessary for the City government to remain financially solvent and institutionally sound.

B. Issuance of Long-Term Bonds

The City must sell long-term, general obligation bonds in sufficient time to have funds on hand to repay \$25 million of bond anticipation notes that mature on June 29, 1984. It should also be emphasized that if the City is unable to sell long-term bonds to repay the \$25 million, the City would have to repay the \$25 million of bond anticipation notes from its own funds; with the City continuing to face budgetary pressures,

it would not appear that the City will have sufficient monies on hand to retire the \$25 million without further cut-backs in operations.

Based on the recent performance of Boston securities in the long-term bond market, it would appear that the City could sell as much as \$45-50 million in long-term, general obligation bonds in the spring, 1984. If the City sells \$45-50 million, approximately half of the bond proceeds would have to be applied to the payment of bond anticipation notes, which have been sold for projects already identified and approved. However, there would be sufficient incremental monies in the bond sale in the range of \$20-25 million representing funds to establish capital priorities and initiatives. The incremental amount of proceeds raised through the bond issue would be available to fund capital projects through the early half of fiscal 1985, until a subsequent issue of bonds or bond anticipation notes has been sold.

There are numerous options with respect to the use of this incremental "new" amount. For example, because of the small amount of capital expenditures that have been made by the City over the last three years, which will be discussed later in this paper, a meaningful funding of capital rehabilitation remains unaccomplished.

It should be emphasized, however, that flexibility in the use of bond proceeds may be limited because of certain court-mandated capital expenditures, mainly the prospective funding of the Charles Street jail. While all the proceeds not used for the repayment of bond anticipation notes would probably not have to be assigned to the court-mandated purpose, if the City is required to participate in this jail financing, a portion of the potential "new" money would be exhausted for this purpose.

Because of recent changes in the City's credit ratings and other adjustments in the City's credit and financial picture, it would appear possible for the City to possibly sell long-term debt in April at nearly twice the level that the City has funded at any time over the previous three-year period. Thus, new programmatic options do exist for determining the application of new bond money.

C. City's Credit Position

The City's access to borrowed funds for meeting its financing requirements discussed above depends on whether the City can demonstrate its ability to repay its incurred debt. The City has been an acceptable institutional name for purchase by some financial institutions, notwithstanding the rating problems that have plagued the City's debt issues. However, this capital has been narrow for the most part over the last several years, limited to a small number of institutional sources of funds.

It is important to stress the fact that the City's ability to finance the requirements discussed above will continue to depend, in large part, on the City's credit ratings, as established by Moody's Investors Service and Standard & Poor's Corporation, the two nationally recognized credit rating agencies. A government's credit rating affects whether its securities qualify as eligible investments for financial institutions (e.g., commercial banks, insurance companies, etc.). In general, if a rating falls within the top four rating classifications, then the security meets the basic credit criteria of these institutions for regulatory approval purposes.

Frequently, questions are asked about the "real" importance of the rating agencies. Obviously, a citizen will

assume that the higher the rating, the better managed are the City resources, but this assumption is only partially true. However, there are significant financial effects of the rating agencies. For example, as a rule of thumb, a distinction from one rating category to the next represents approximately one half of one percent in interest costs on a long-term bond issue. Thus, the difference between a AAA rated municipality and a Ba-1 rated municipality may be as much as 2-1/2 percentage points for a bond issue. Assuming a \$30 million issue with comparable repayment schedules, the Ba-1 governmental entity may pay as much as \$7.5 million more in interest costs over the life of the securities.

The City's credit ratings assigned by the national credit rating agencies have limited the appeal of the City's securities. In general, the City's credit ratings resemble those of most cities in the Northeast. By one rating agency, the City is rated slightly above most other cities in the region, while the other agency rates Boston on the same level, or slightly below other Northeastern cities. First of all, Boston has experienced a decline in ratings simply because of its location and the rating agencies' perspective that the credit for Northeastern cities has generally experienced a generic deterioration, primarily, with respect to their economies. The agencies cite a decrease in relative wealth levels, stagnation in property

values, greater dependency on intergovernmental revenues and similar items for many of these cities. These characteristics are often found in credit reports on sizeable Northeastern cities, including New York City, Philadelphia, Pittsburgh, Boston, Newark, Buffalo, Cleveland, Detroit, Camden, etc. However, both agencies have also noted four other special negative factors in quantifying Boston's credit position. First, they identify the large fixed costs that the City must pay (e.g., pension payments, debt service, MBTA payments and transfers to such entities as the Health and Hospitals Corporation). Second, they indicate that the City's economic growth has not been translated directly into revenue sources for use by the City to meet ongoing City expenditures. Third, they frequently cite that the City has virtually no revenue flexibility in light of its high dependency on property taxes, particularly taking into consideration the restrictions of Proposition 2-1/2. Fourth, the agencies consider that the budgetary effects of the City's disproportionate assessment liabilities and the passage of Proposition 2-1/2 have further undermined the stability of the City's financial standing. Unfortunately, most of these matters can not be resolved overnight. These represent structural problems, which need a long-term financial strategy.

It should be noted that over the recent past, the credit rating agencies have become convinced that the economy of Boston may be substantially different from many of the static economies of other cities in the Northeast. Nevertheless, without the ability to translate economic resources into substantive revenue sources to meet recurring operating and other obligations, Boston has not yet received a major favorable adjustment in its rating from the agencies.

As evidence of the rating community's misgivings about one aspect of the City's credit (e.g., the revenue structure of Massachusetts municipalities), Standard & Poor's Corporation lowered the City's credit rating one level in December, 1980, one month following the passage of Proposition 2-1/2, and Moody's Investors Service withdrew in March of 1981, four months after the passage of Proposition 2-1/2, the ratings for forty-four local governments, citing, as a principal reason, the uncertainty surrounding the legislative prospects for adequately addressing the key fiscal and debt management problems created by Proposition 2-1/2. At the time, Moody's indicated that by late June of that year, it would begin the process of reinstatement of ratings, although not necessarily at the previous levels. True to its word, Moody's began this process over the summer, and, at the completion of the process, 75% of the Massachusetts localities had been downgraded, and the

remaining localities were assigned to their previous classifications. Boston was one of the Massachusetts municipalities which had its rating reduced one level - this time, to Ba, a non-investment grade category.

For the most recent, general obligation bond issue that was sold by the City for capital construction purposes, both rating agencies were inclined to rate the post Proposition 2-1/2 debt on the same basis as the pre-2-1/2 debt at Ba-1 for Moody's and BBB+ by Standard & Poor's Corporation, notwithstanding the fact that the general obligation debt sold subsequent to the passage of 2-1/2 was supported by limited taxing authority, while the debt sold prior to the passage was supported by the City's unlimited taxing powers. After considerable discussions with the agencies, it was concluded by the agencies that a pragmatic approach toward the City's rating for new debt was appropriate, since it would take an extraordinarily distressful condition to occur financially for the technical differentiation regarding debt service on the limited and on the unlimited debt obligations to be operative. This approach by the agencies does offer some greater flexibility than would appear on the surface - that is, investors holding debt obligations secured by the City's unlimited taxing pledge would not experience deterioration in credit quality by purchasing new debt obligations.

In order for Boston to have improved access to large pools of investable funds, the City's credit must be perceived favorably by the rating agencies.

III. Background/History/Contextual Factors

To gain some further insight into the current credit problems facing Boston, it is important to examine the context of various matters affecting the City's current credit picture. These factors are frequently cited by underwriters, investors and rating agencies as credit features impacting their view of Boston securities.

A. Level of Public Service

One important issue is the degree of financial responsibility that Boston has for public services. Boston raises and spends almost twice as much per capita as do comparable cities across the nation. This occurrence is largely accounted for by the fact that other forms of government (e.g., counties, special districts, and school districts) are much more active in raising and spending funds across the nation than they are in New England. The two major examples of this are illustrated by the fact that Boston, not a school district, directly finances the City's public school system and Boston again, not another government entity, has major health and hospital financing responsibilities.

B. Heavy Reliance on Property Taxes

A second major issue is the heavy reliance of Boston on property taxes, which has been virtually unsurpassed by major American cities. However, as a result of Proposition 2-1/2, in 1982, the City had to reduce its property tax \$78 million from the 1981 level of \$518.7; in 1983 and 1984, the City's tax levy was reduced by 15% and 12.6%, respectively.

As a result, Boston has had more demands on its revenue raising powers than most other cities of comparable size and structure around the nation. Cities in most other states are also able to rely on general or selective sales taxes as an additional source of revenue.

C. Disproportionate Assessment Refunds

Another factor that negatively impacted the City's finances resulted from the 1979 decision in the case of Tregor v. Assessors of Boston. As a result of this decision and related ones, the City had to refund certain taxes that it had collected from commercial property holders. These liabilities, which will ultimately require a cash outlay in excess of \$100 million, has put extreme pressure on Boston's credit position and financial flexibility. To address the fund problem poised by the City's disproportionate assessment liabilities and related credit and financial problems, the Funding Act of 1982 was passed. The

Act authorized the issuance of \$45 million in Funding Loan Bonds and provided for the sale of the Hynes Auditorium in fiscal year 1983. The Act also established an excise tax on hotels and motels in the City, an excise tax on the recording of deeds, instruments and writings filed with Suffolk County, an excise on condominiums and real estate consolidation, and authorized the City to charge an "augmented fire services availability" fee for certain structures which place special burdens on the City's fire protection services. This latter fee has been enjoined by the Supreme Court on the grounds that it was not proportionately assessed.

D. Control over Department Revenues

Over the years, one additional financial problem which has been identified as a significant credit factor was the City's limited degree of financial control over its departments. Certain provisions of the 1982 Funding Loan Act make City departments, notably the School Department, subject to expenditure control through a system of quarterly spending allotment. These allotments are to enable the City Auditor to keep track of the rate of departmental spending and give the Mayor the power to decide to waive enforcement of the allotment limit depending on circumstances. The Act also establishes certain mechanisms that limit the flexibility of financial administration, in particular, the ability to transfer

appropriations between departments. While some concern still exists among various sectors of the financial community regarding the financial control over City departments, this new structure has assisted in enhancing the City's credibility in the credit markets for the City's financial operations.

E. Debt Structure

Certain other historical factors that impact on the debt finance and debt management operations of the City fall into a category which can be classified as "debt structure".

Among the more important items in debt structure is the absolute level of debt burden. During most of the recent past, Boston's debt load, as calculated by the rating agencies, was among the highest of cities throughout the country. In general, debt burden reflects tax-supported indebtedness related to available taxable resources (i.e., full taxable value of property located within the City). Until the completion of the revaluation in fiscal 1983, the rating agencies relied on either equalized value or a highly conservative estimate of the City's full taxable value (e.g., \$5-6 billion). However, with the taxable value established through revaluation at \$12.2 billion, the calculated debt load was reduced by approximately 50%. In fact, the City's debt burden now approximates the median for cities of populations of 500,000 and above.

The second important debt structure issue involves the City's maturity schedule and the rapidity of its debt retirement. The rating agencies use a rule of thumb that indicates that the repayment of debt should approximate 50% of total outstanding debt within ten years and 25% within five years. The City's bonds currently mature in an amount of approximately 41% in five years and in excess of 81% in ten years. While the City recaptures debt capacity in a relatively short period of time as a result of this rapid rate of principal repayment, the maturity schedules place significant pressure on the City's operating budget to meet these scheduled payments. In the face of the significant budgetary pressures that the City already faces, this additional pressure reduces the financial flexibility to manage its services and operations effectively.

F. Unfunded Pension Liability

The City provides pension benefits through a contributory retirement system, the State-Boston Retirement System ("S-BRS"). The City meets its share of the contributory cost on a pay-as-you-go basis by contributing annually to the fund. The City's annual contribution is a legal obligation that must be included in the tax levy.

The net appropriated contribution of the City to the S-BRS was \$75.5 million in 1982 and \$75.8 million in 1983.

According to some estimates, the City has a total actuarial pension liability of \$1.79 billion as of June 30, 1982. The market value of accumulated assets of the S-BRS reserved for funding purposes was estimated to amount to \$293.5 million at June 30, 1983; hence, the total unfunded liability was approximately \$1.56 billion.

The City estimates that the net unfunded actuarial liability of S-BRS actually aggregates approximately \$1.2 billion. Due to the City's limited financial resources, the City is not funding either the \$1.2 billion unfunded liability, nor the accruing, but not payable liabilities out of its current operating revenues. Only the pensions associated with the City's Department of Health and Hospitals is funded from current revenues.

A rising expenditure for a fixed cost item, such as pensions, without a concomitant revenue increase, creates, over the near future, less flexibility for the City to meet other financial obligations.

G. Other Items That Impact Current Operations

There are several other factors that have frequently been raised by rating agencies, underwriters and institutional investors, as causing concern regarding the impact of these matters on the City's prospective financial operations.

1. State Aid

State aid by the Commonwealth to Massachusetts municipalities has increased in recent years. The City received \$269.6 million for general fund purposes in fiscal 1983 which represented an increase of \$42.4 million from fiscal 1982. The City expects to receive approximately \$302.7 million in fiscal 1984, an increase of 12.3% over 1983's figure. On a percent basis, State aid composed 31% of the City's revenues in fiscal 1983 and is estimated to compose 32% in fiscal 1984. This increase in State aid has helped to offset the effects of Proposition 2-1/2.

The importance of State aid to the City has grown since the passage of Proposition 2-1/2. Since the Proposition limits the property tax levy in any city or town to 2-1/2 percent of the value, once the limit is reached, no new levy in a future fiscal year can exceed, without voter approval, the previous levy by more than 2-1/2 percent.

The continuation of a sizeable level of State aid will affect the response of the investment community to the City's credit. However, even with the increase of State aid, municipal bond analysts frequently cite the fact that the City's receipt of State aid is dependent on the State's annual appropriation process, which makes these funds less certain than monies directly under control of the City. Second, they also fre-

quently stress that State aid is a highly indirect way of the City receiving the financial benefits of the economic activity that occurs within the City of Boston.

2. Federal Aid

Boston's financial picture has benefited extensively from the Federal programs for urban renewal and employment and training. However, in recent years, direct Federal aid to Boston and other large cities has declined. In fiscal years 1981 and 1982, the City received \$133.5 million and \$98.9 million respectively in Federal revenues. Further, the City's Federal aid receipts declined to approximately \$71.6 million in fiscal year 1983. Part of this decline is related to the general decline in funding for Federal programs and partially reflects changes in the City's demographics resulting in lower funds for the City.

A decrease in Federal aid payments combined with the other budgetary pressures for the City is cited by municipal analysts as causing further operating and financial cutbacks.

3. Non-Recurring Revenues

As part of the 1982 Funding Loan Act, the City was authorized to issue \$45 million in bonds and to sell the Hynes Auditorium to the State and to dispose of other surplus properties. Funds from these non-recurring sources were to be used primarily for the retirement of the remaining Tregor liabil-

ities, but any excess funds were credited to the City's General Fund. A portion of the \$45 million bond issue and the monies available from the sale of Hynes and four municipal parking garages will be available on a net basis for fiscal 1984 general revenues. These additional revenues are expected to improve the overall liquidity of the City's finances in fiscal 1984 since they will help offset fiscal 1983's operating deficit. However, these monies will not be available for meeting the City's fiscal 1985 financial obligations, which will create a sizeable budgetary gap, requiring either additional expenditure reductions or extensive revenue enhancements.

4. Labor Union Contracts

The largest component of the City's financial obligations consists of personnel costs. At present, the future financial responsibilities of the City for meeting these costs are unknown, since labor contracts have yet to be settled with the terms for large retroactive payments and prospective salary levels still being negotiated. It appears that these unresolved labor payments and contracts will not be dealt with until the next administration takes office. The size and terms of the settlements will have a major effect on the City's future finances, and this fact has been emphasized recently by many participants in the credit markets.

5. Other Fixed Costs

a. Health and Hospitals

The City of Boston provides extensive health services including, but not limited to, the operation of neighborhood outpatient health clinics, and several hospitals, including Boston City Hospital. These services are funded by a combination of revenue generated through fees for health services and transfers from the City's General Fund. In 1982, this transfer from the General Fund amounted to \$19 million. On October 1, 1982, a new third-party reimbursement system for the City's acute care facilities was established. As a result of this new system, revenues from the operation of the City's Health and Hospitals department were estimated to total \$110 million in fiscal 1984 in comparison to approximately \$94.5 million in fiscal 1983. Even though the revenues have increased in fiscal 1984, the City anticipates that the cost of providing medical services will continue to exceed revenues generated from the new system since the reimbursement system does not cover all the patients the City serves. In fiscal 1983, the operating transfer is expected to increase due, in part, to \$8 million of Medicaid overpayments to the City in fiscal 1982. Additionally, the transfer to the department is likely to increase in fiscal 1983 and beyond since the new reimbursement system is based on a set and regulated charge rate. Hence, cost reim-

bursements to the City may lag behind costs as the charges have to be approved by the Commonwealth's Rate Setting Commission.

b. Massachusetts Bay Transportation Authority
("MBTA")

The MBTA provides rapid transit and other mass transportation services to Boston and 78 other outlying cities. The MBTA has and is expected to continue to run an operating deficit (the excess of current expenses, including debt service, over current revenues). To meet these consistent operating deficits, the MBTA has had three revenue sources: (1) state general fund payments, (2) federal operating assistance under the Urban Mass Transportation Act Section 5 (which have been greatly reduced in recent years, and (3) assessments on cities served by the MBTA. Boston's assessment has usually amounted to approximately 42% of the total annual assessment.

The Commonwealth has increased its annual appropriations to the MBTA which, in turn, directly reduces the net cost of the MBTA's service deficit assessed to the served cities. In fiscal 1982, the MBTA deficit was approximately \$251 million. Of that amount, the Commonwealth's share was approximately \$140 million, and the City's share was nearly \$41 million. The balance of the deficit was covered by Federal Operating assistance and assessments on other cities. It should

be emphasized that the annual growth of the local assessments on all the cities served by MBTA is limited to 2-1/2 percent of the prior year's assessment. Hence, the amount assessed on the City of Boston is limited to increases of 2-1/2 percent per year, no matter the size of the MBTA's deficit.

IV. Primary Decision Considerations and Strategies

A. Bonds For Financing New Capital Construction

Since the \$25 million bond anticipation note must be retired on June 29, 1984, it is strategic to use that opportunity to achieve a number of ends. If a bond sale of between \$45-\$50 million is achievable in Spring 1984, approximately half of the bond proceeds could be applied to the retirement of the \$25 million bond anticipation notes, with the other half being used to fund a program of capital projects. The incremental amount of proceeds raised through the bond issue would be available to fund capital projects through much of fiscal 1985, until subsequent bonds or bond anticipation notes are sold.

For the fiscal years 1978 through 1980, capital expenditures ranged between \$45 million and \$65 million which were funded out of long-term debt. Proposition 2-1/2 and the uncertainties surrounding the City's liabilities for the disproportionate assessment refunds severely reduced the City's ability to issue long-term debt and hence resulted in substantially reduced capital expenditures during the fiscal years 1981-1983. Indeed, capital expenditures amounted to approximately \$24.7 million in fiscal 1981, \$7.6 million in fiscal 1982 and an estimated \$20 million in fiscal 1983.

Needless to say, there are a large number of unfunded capital infrastructure needs as a result of this significantly reduced level of funding. As stated above, the City's flexibility in choosing between capital projects may be limited as a result of certain court-mandated capital expenditures, including approximately \$7 million to complete the first phase of the rehabilitation work on the Charles Street Jail, and an estimated \$3 million to renovate two City high schools. While the \$45-50 million bond issued in April, 1984 will provide the City with funds for capital projects, some of these funds may be seriously restricted.

While numerous studies have concluded that Boston's physical plant is in need of substantial capital expenditures, the largest capital expenditures planned for Boston are for mass transit, highways and bridges, and water and sewer improvements. The funding for these infrastructure projects is not the responsibility of the City itself. Mass transit needs are provided by the MBTA which is funded principally from the Federal and State governments and from assessments on cities it serves.

Similiarly, the City's highways and bridges needs are the responsibility of the State, the Metropolitan District Commission or the Federal Government. In fact, Boston has financed no major street improvements without Federal or State assistance,

and virtually all of the capital repairs or replacement of Boston's bridges are carried out with State and Federal funds.

While Boston water and sewer physical demands are quite large as evidenced by the fact that more than twenty percent of the City's water distribution system was built before 1900 and that seventy percent of Boston's sewers were laid before 1910, the City finances none of the capital needs in this area. The State created the Boston Water and Sewer Commission in 1978 and authorized it to sell revenue bonds backed by water fees and charges to finance all water and sewer capital expenditures in the City. Hence, while Boston has numerous capital needs, the most immediate of these are not the responsibility of the City. There are a number of categories of capital requirements that are the City's responsibility (e.g., parks, City-owned and maintained roadways, and parks). Yet the opportunity exists for using borrowed monies beyond these responsibilities.

As a result of the increased amount of City bonds that can now apparently be sold, a key public policy issue will be the purposes for which future borrowed capital construction funds will be employed.

B. Debt Repayment Schedule

Legislation is now pending in the Commonwealth which would improve the City's debt management operations in many respects.

Among the important issues that this legislation addresses is the authorization for the City of Boston to extend the period over which debt may be repaid. It would be good public policy for the City to have the capacity to reduce the amount of current operating funds that must be employed to repay principal annually. This approach does not suggest that a substantial shift should occur, but it does recommend a more conventional approach be adopted, approximating the rating agencies' rule of thumb of 25% of principal being repaid in five years and 50% in ten years. Not only would this occurrence improve the operating burden of the City in terms of reducing fixed costs, but it would also improve the credit standing of the City among institutions and in the investment community which should result in lower capital financing costs for the City.

C. Cash Flow Integrity

Access to borrowed funds for meeting cash flow requirements relies on the integrity of the City's cash flow operations. Therefore, it will be important for the City to show significant restraint in expenditures so that the City can demonstrate adequate coverage of principal and interest on the notes to be issued in anticipation of tax receipts. Without this demonstration of fiscal integrity, the City will be restricted in its ability to achieve financing for cash flow purposes. In this case, without access to funds for meeting these purposes, the

political and institutional authority of the City will be jeopardized; in addition, the roles of other units of government and other groups, including the financial community and large recipients of City funds (e.g., City employees), will then become much more important, conceivably restricting the capacities and the authority of the elected leadership.

D. Use of Revenue Bond Financing

There were a series of reasons for the creation of the Boston Water and Sewer Commission, some of which relate to good debt management. For example, over the recent past, because of a number of problems that issuers of general obligation debt had experienced (e.g., New York City and Cleveland), in which defaults occurred and for other related reasons, including the use of more specific contractual provisions, the appeal of revenue bonds substantially grew. Moreover, in many circumstances, the rating agencies will apply a significantly higher rating on revenue bond securities than they will on general obligation debt, particularly in those circumstances in which the underlying general obligation issuer has important visible credit problems.

It should be emphasized the higher the rating, the lower the debt financing cost will be to the citizens. In this respect, the Water and Sewer Commission has proven to be a less expensive way of financing water and sewer capital expenditures than

they would have been through the City itself. For example, at present, the Water and Sewer Commission is rated Baa-1 by Moody's and A by Standard & Poor's, both of which are meaningfully higher than the rating on the City's general obligation debt. Thus, capital financing costs through the Boston Water and Sewer Commission are below those for City general obligation debt.

It would be important, therefore, for the City to consider ways in which to finance capital construction expenditures, wherever possible, on a revenue bond basis. In those cases where it will appear that a revenue structure is appropriate in which fees and charges rather than general taxes would be employed to repay indebtedness, and appropriate contractual arrangements can be established for this purpose, the City should pursue this revenue bond approach.

Another good example of the use of revenue bond financing for capital requirements involves a project in which the City is now engaged. The City is currently preparing the package for financing of a resource recovery project to eliminate solid waste refuse from the City. The cost of landfill and the lack of availability of appropriate landfill sites have limited the use of this approach for removing solid waste. The major features of the resource recovery project involve the City paying a tipping fee to a joint venture company, composed of

Browning-Ferris and Air Projects, which will in turn process waste material and generate steam which Boston Edison has agreed to purchase. At present, based on the current schedule of activities, it is expected that the Industrial Development Finance Authority of Boston will sell tax-exempt, revenue debt for this project during the summer of 1984. The intent of this program is to provide solid waste disposal at attractive operating and capital costs to the City.

The more extensive use of revenue bonds can be more attractive financially to the City, at least as long as the current credit ratings of the City remain in place.

E. Alternative Funding Options

The market into which the City of Boston sells its securities has changed significantly in recent years. During much of the seventies, most of the debt sold by governmental entities was general obligation debt, secured by the entities' general taxing powers. Recently, a major shift has occurred, with most tax-exempt debt now being sold as revenue bonds, secured by particular fees and charges. In addition, institutions had utilized the tax-exempt interest feature of governmental securities to a greater extent than they presently do; reliance by the institutions on other tax advantages (e.g., leasing, foreign tax credits, etc.) has reduced the attractiveness of tax-exempt securities. As a result, the pool of institutional investable

funds has decreased, and the interest rate differential between taxable and tax-exempt rates has also narrowed.

Alternative approaches to financing governmental capital requirements have grown in response to the changing composition of the market. In fact, the use of greater private sector participation through service contracts and other direct assistance has expanded. The substitution of private credit for public credit through back-up bank guarantees, insurance, etc., has become more prevalent. Also, various forms of leasing arrangements have become popular, such as sale/leaseback and lease/purchase programs.

A new approach toward the financing of Boston equipment and vehicles has recently been implemented. For the current 1984 fiscal year, the City has negotiated an agreement with Gelco of Minnesota to finance all of the City's lease-purchase items for the entire fiscal year. Boston is one of the few cities in the country to have a master lease program. Most lease-purchase-type financings are done on an individual basis (i.e., financing of computers, vehicles, wordprocessors, etc., separately); this approach frequently produces duplicative and costly administrative charges since new documents and arrangements are used and applied for each lease. However, with a master lease program, one document is prepared for one source of funding which finances all of the lease-purchase items for

the entire year. In addition, certain additional investment income can occasionally be achieved when all of the money can be drawn down at once at the beginning of the fiscal year and invested at taxable rates. The City then receives the differential investment income between its tax-exempt rate and the taxable rate until monies are actually needed to buy the individual items. It will be important for the City to seek out opportunities for alternative, cost-effective financing vehicles, in order to adapt to the changing and frequently less attractive bond and note markets.

F. Internal Implementation of Capital Construction Program

In the 1960s and late 1970s, the City of Boston had an active capital improvement program and accessed the long-term market on a routine basis to fund capital projects. However, events in recent years have prevented the City from entering the long-term market and as a result, the City's capital improvement program was significantly reduced. As stated previously, the emphasis of City financial and debt management shifted principally to the short-term market for meeting the City's operating requirements. The City enhanced its planning and execution ability in the operations of the short-term market. Since increased capital expenditures are projected again for fiscal 1984, the City will need to concentrate on the internal

organizational capacity to plan and implement a successful capital construction program.

G. Participation of State Aid

The inability of the City to raise the tax levy in future fiscal years greatly limits the City's ability to utilize its developing business economy. The primary way the City will be able to take advantage of its economic development for increased revenues is through an indirect means of taxation. One such indirect means is through the Commonwealth's appropriated funds. The Commonwealth's revenue structure is much more sensitive and responsive to economic growth than the City's. As a result, the City's financial strength is vitally linked to State aid, not only to compensate for the reductions in property tax levies, but also to enable the City to generate revenues from the surge of economic activity in the City. Taking into account the sizeable reduction in recent Federal aid payments to Boston, it will continue to be very important for the City to pursue a strategy which will annually result in adequate State funds being available as a recurring City revenue source.

H. Other Improvements to the City's Credit Condition

A variety of approaches can be employed to improve the City's credit position. Most of these approaches require the

development of a long-term strategy; however, there are others which can be achieved in less time.

In general, most approaches for improved credit results require an incremental strategy. It should be noted that even with an incremental approach, to the extent that improvements can be reached for many of the credit items previously identified, the market will improve for City obligations, resulting in lower interest charges being applied to City securities with City residents paying lower debt service costs.

Some of the credit items previously identified (e.g., labor contracts, departmental spending, etc.) can be addressed through good internal financial management, which is thoroughly recommended as an important tool for favorable credit response. However, there are other factors that will require implementation of a longer term strategy. For example, until the City has more revenue flexibility, it will not be possible for Boston's financial condition to be fully viable. Some form of expanded tax structure which allows the City to have more direct access to increased economic activities and resources located within its boundaries would improve the responsiveness of the investment community to the City of Boston's credit.

As stated previously, the investment community has identified the high level of fixed costs of the City as a reason for responding in a more negative way to the securities sold by

the City. These fixed costs include pension funding, debt service, the MBTA deficit, Health and Hospital transfers and similar items. The importance of these fixed costs grows when the revenue structure limits the level at which revenues increase. For example, the City for many years has been engaged in providing large subsidies, most recently, ranging from \$15-35 million per year, for the provision of health care through the City's Health and Hospitals Corporation. Faced with a fairly static revenue base of own-source revenues, the City is unable to increase its own revenues at a rate equal to the recent levels of inflation for health care. Thus, taking into consideration that the deficit of Health and Hospital Corporation may increase significantly over the foreseeable future, to the extent that the City relies upon its general revenue to finance higher subsidies to Health and Hospital Corporation, it will have to achieve cutbacks in other areas of operations. Thus, some action should be taken in the near term to mitigate the deleterious effect of Health and Hospitals on the financial well-being of the City. Several studies have been conducted on alternative approaches for dealing with this financial problem: it does appear that only an altered approach to health care operations could have major beneficial and financial consequences for the City. This approach toward

altering operations for subsidized programs will be needed to balance City resources against liabilities.

In addition, however, it may be possible to combine the elimination of certain fixed costs, (i.e., pension funding and the MBTA deficit) by combining those costs with some form of revenue enhancement. In other words, it may be possible for one or more of the fixed cost items to be financed through another revenue source that more directly reflects the economic realities of the particular circumstances.

Summary and Conclusion

In conclusion, the debt finance and debt management issues facing Boston in 1984 are substantial, but taken in context, suggest that the City's 1984 debt and credit policies should be directed toward meeting the immediate financial needs while at least protecting, if not enhancing, the City's current credit position. The City faces a thin cash flow early in 1984 and has to retire \$25 million of bond anticipation notes on June 29, 1984. As a result, the City faces an immediate need to issue long-term, limited tax bonds in spring, 1984 in order to avoid a potential serious cash flow shortfall.

The City also has an ongoing need to access the short-term market to keep itself solvent. First, the City routinely experiences a thin cash flow balance at various points during its fiscal year. Second, the majority of property taxes, which represent the principal source of revenues, is received in November and May of each year. Hence, the City will have to issue short-term debt annually in an amount of approximately \$65 million in most years. Thus, the City's ability to convince investors to purchase short-term debt to finance these shortfalls will depend on the maintenance and enhancement of the City's basic credit worthiness.

As history demonstrates, cash flow shortfalls result in political and financial crises with effects that linger well beyond the year of the shortfall. In issuing long-term debt late in fiscal 1984, the City could sell as much as \$45-50 million in long-term, general obligation bonds. If the City sold securities in this amount, approximately half of the bond proceeds could be applied to the payment of the bond anticipation notes, with the other half of "new" funds being available to fund capital projects in fiscal 1985. There are numerous capital and rehabilitation purposes that could be financed by these "new" monies, though some of which may be restricted by court-mandated expenditures.

While the \$45-50 million debt issue would meet the immediate financial needs, special emphasis must be given to enhancing Boston's credit position in 1984 and beyond. There are four major factors that have been identified by credit analysts in the financial community as negatively impacting the City's credit position. The first is the large degree of fixed costs: The City's expenses for education, health and hospitals, debt service, mass transit and pension are financed directly from the City's operating budget. These expenses put substantial pressure on Boston's limited revenue sources and as a result, cause concerns about Boston's ability to access sufficient revenues to pay all of its obligations.

The second factor that negatively impacts Boston's credit standing is the inability of the City to translate its economic resources into a revenue source. The City's ineffectiveness is largely due to the restrictions imposed on its ability to impose and raise taxes. As a result, the City's revenue sources are largely unresponsive to any economic upsurge occurring in Boston. One strategy to turn some of the economic activity into revenues for the City may be to continue to access state aid which is made available through annual appropriations by the Commonwealth, since state revenues are more sensitive to economic activity. However, this source is indirect and is subject to annual appropriation; expansion of revenues that are more under the control of the City itself would be met more favorably by the credit markets.

The third factor limiting Boston's credit position is the City's inflexible revenue sources, especially its dependency on property taxes, which are now subject to special budgetary limitation. Boston's tax structure is highly restricted and, as a result, will continue to hinder the City's credit worthiness.

The fourth negative factor is the disproportionate assessment refunds that have been and will continue to be paid by the City. The financial strain imposed by these claims served to further weaken Boston's financial situation. Monies the

City committed to pay these refunds were not available for other potential City uses. However, it appears that the payment for the majority of these liabilities has been established, and the credit problem imposed by these liabilities has been lessened in fiscal 1984. Until all of the Tregor and related obligations have been retired, the specter of the remaining payments for these liabilities will remain a credit concern to the investment community.

Other factors, including among others, the outcome of the City's labor negotiations, the need to alter the City's debt repayment schedule, etc., will also impact the perception of Boston's securities and its ability to attract the necessary investors for the City's bond and note financings. The City will have to actively pursue those policies and procedures that will strengthen the City's credit in the eyes of credit analysts and potential investors in order to ensure that the City maintains the sound debt finance and debt management necessary to keep the City financially and politically viable.

Biographical Sketch of J. Chester Johnson

J. Chester Johnson is chief executive officer of Government Finance Associates, Inc., which provides independent financial advisory services, primarily in connection with the issuance of debt securities, to state and local governments and authorities. Mr. Johnson has been active in the tax-exempt finance field since 1968. For several years as a credit analyst for tax-exempt issues at Moody's Investors Service, the national credit rating agency, he was in charge of ratings assigned to securities sold by state and local governments and their authorities for a ten-state area. In 1972, Mr. Johnson joined Morgan Guaranty Trust Company of New York where he became Vice President and Head of the Public Finance Research and Advisory Group. In this capacity, he was responsible for approving tax-exempt securities purchased by the bank and for advising state and local governmental issuers on debt management matters.

In addition, Mr. Johnson has been active in industry-related matters, including the development of disclosure standards for the tax-exempt market as a member of the drafting committee, Disclosure Guidelines for Offerings of Securities By State and Local Governments, published in 1976 by the Municipal Finance Officers Association. In 1977, he was nominated and appointed to the position of Deputy Assistant Secretary for State and Local Finance at the U.S. Treasury Department. In this role, Mr. Johnson was responsible for, among other duties, administering the Federal Government's loan program to New York City and assisting in the development of Administration policy and programs affecting state and local finances. Mr. Johnson has written and spoken extensively on the subject of tax-exempt financing. Among the groups he has addressed are the National League of Cities, the U.S. Conference of Mayors, National Conference of State Legislatures, Council of State Governments, National Governors Conference, and the Municipal Finance Officers Association. Mr. Johnson received his education at Harvard College and the University of Arkansas.

